D.P.U. 95-101

Application of New England Power Company, pursuant to G.L. c. 164, § 14, for authorization and approval of one or more additional issues of General and Refunding Mortgage Bonds; the execution of one or more loan agreements or supplemental loan agreements in connection with refinancing outstanding Pollution Control Revenue Bonds; execution of one or more Hedging Agreements; and an exemption from the provisions of G.L. c. 164, §§ 15 and 17A.

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FOR: NEW ENGLAND POWER COMPANY
Applicant

I. INTRODUCTION

On August 21, 1995, pursuant to G.L. c. 164, § 14, New England Power Company ("NEPCo" or "Company") filed a petition with the Department of Public Utilities ("Department") for authority to implement a refinancing plan under which NEPCo would: (1) issue up to $68.35 million principal amount of one or more series of General and Refunding Mortgage Bonds ("G&R Bonds"); (2) execute one or more loan agreements or supplemental loan agreements in connection with refinancing outstanding Pollution Control Revenue Bonds ("PCRBs"); and (3) execute one or more interest-rate hedging agreements in conjunction with its proposed refinancing. The Company also requested an exemption from the advertising and competitive bidding requirements outlined in G.L. c. 164, § 15 and an exemption from the requirement of G.L. c. 164, § 17A which requires Department approval for a company loan, guaranty, endorsement or investment of its funds.

Pursuant to notice duly issued, the Department held a public hearing at its offices in Boston on October 16, 1995. At the hearing, the Company presented the testimony of Lily M. Lee, senior financial analyst for NEPCo, in support of the Company's petition. The evidentiary record consists of seven exhibits, including: the prefiled testimony of Ms. Lee (Exh. NEP-1); the pre-filed financial exhibits of NEPCo (Exh. NEP-2); a diagram of interest rate swaps (Exh. NEP-3); a revised comparison of net utility plant to total capitalization (Exh. NEP-4) and the Company's petition (Exh. NEP-5); and two responses to Department record requests. No petitions to intervene were filed.

NEPCo is a Massachusetts corporation and a subsidiary of New England Electric System

("NEES"). NEPCo is qualified to do business as a foreign corporation in the states of Connecticut, Maine, New Hampshire, Rhode Island, and Vermont (Exh. NEP-1, at 1-2). NEPCo generates, purchases, transmits, and sells electricity at wholesale (id.).

II. DESCRIPTION OF THE PROPOSED FINANCING

A. G&R Bonds and PCRBs

The Company seeks authority from the Department to issue, through December 31, 2001, up to $68.35 million principal amount of G&R Bonds, with a maturity not to exceed 30 years at either a fixed or variable rate of interest (id. at 2). The Company stated that these bonds will be issued to the Business Finance Authority of New Hampshire ("BFA") and the Connecticut Development Authority ("CDA"), (collectively referred to herein as the "Issuing Authorities"), to support the issuance and sale of PCRBs by the Issuing Authorities (id.).[1]

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[1] As indicated by the Company, pursuant to enabling legislation, various public agencies can issue bonds to finance pollution control equipment constructed by private corporations. Typically, the agency and the

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corporation will enter into a loan agreement. Under the loan agreement, the agency will agree to issue PCRBs to the public and lend the proceeds from the sale thereof to the corporation in exchange for the corporation's promise to make payme

In order to refinance the PCRBs, the Company proposes to execute one or more loan agreements with the Issuing Authorities (id. at 2-3). The proposed PCRBs may be sold by each of the Issuing Authorities through competitive bidding, through negotiation with underwriters, or through negotiation directly with investors (id. at 6-7). The Company stated that the proceeds from the proposed issue of the PCRBs will be used to refinance up to $68.35 million of the face amount of PCRBs previously issued on the Company's behalf by the Issuing Authorities (id. at 2). Specifically, in May 1986, the Company issued $29.85 million of its Series L (7.80 percent) G&R Bonds, due in the year 2016, to the BFA in connection with pollution control equipment at the Seabrook 1 nuclear generating station (id. at 4). In October 1989, the Company issued $38.5 million of its Series K (7.25 percent) G&R Bonds, due in the year 2015, to the CDA in connection with pollution control equipment at the Millstone 3 nuclear generating station (id.). The Company also stated that the proceeds from the sale of the proposed PCRBs may be held in

nts to the agency sufficient to pay the principal of and premium, if any, and interest on the bonds (id. at 3).

trust and invested by the trustee pending distribution to retire the existing PCRBs (id. at 4; Tr. at 11.)

The Company proposed to retire existing Series L and Series K G&R Bonds when they are callable (id.). The Series L G&R Bonds are callable on April 1, 1996 at a price of 102 percent, and the Series K G&R Bonds are callable on October 15, 1999 at a price of 102 percent, which declines over time to 100 percent in 2003 (id.). According to the Company, it would refinance the Series L & K G&R Bonds if market conditions make refinancing economical (id. at 5). The Company stated that at interest rates below 7.65 percent the Series L G&R Bonds are economical to refinance and that at interest rates below 7.10 percent the Series K G&R Bonds are economical to refinance (id.). To allow for fluctuations in market conditions, the Company proposed an interest rate ceiling of 12 percent on new G&R Bonds issued to support PCRBs with a variable rate[2] and an interest rate ceiling of 7.65 percent on new G&R Bonds with a fixed rate (id.).

B. Interest Rate Hedging Agreements

1. Interest Rate Swaps

The Company currently has authority, until December 31, 1996, to enter into one or more interest rate swap agreements in notional[3] amounts not to exceed $617 million. See New England Power Company, D.P.U. 91-267, at 14-15 (1992). The Company has requested certain

[2] The Company stated that if variable rate PCRBs were issued, the interest rate could be reset as often as necessary; the term would be selected by the Company based on current market conditions (id. at 6).

[3] A specified principal amount agreed to by the parties.

modifications, including a five-year extension, until December 31, 2001, to exercise this authority (Exh. NEP-1, at 8). Further, the Company has proposed to expand its current interest rate swap authority to include interest rate caps ("caps") and interest rate collars ("collars") and to reduce its current authority to notional amounts not exceeding $410.35 million, which is the aggregate amount of all outstanding issues of G&R Bonds issued to support PCRBs (id. at 8-9).

The Company stated that an interest rate swap is in effect an exchange of interest payments between two parties -- NEPCo and a counterparty[4] -- for a notional amount for a specified period (id. at 9). According to Ms. Lee, interest rate swaps are used to synthetically create floating or fixed rate obligations (id.). Ms. Lee explained that a company can synthetically create a floating rate obligation by issuing fixed rate bonds and entering into an interest rate swap whereby it receives a fixed rate and pays a floating rate (fixed-to-floating interest rate swap) (id.). Likewise, Ms. Lee stated that a company can synthetically create a fixed rate obligation by issuing floating rate bonds and entering into an interest rate swap whereby it receives a floating rate and pays a fixed rate (floating-to-fixed interest rate swap) (id. at 9-10). The witness stated that, in general, the parties exchange the net of fixed and variable payment but there is no exchange of principal between the parties (id. at 9).

2. Interest-Rate Caps and Collars

The Company also proposed to expand its current hedging authority to include interest rate caps and collars (id. at 8). The witness stated that an interest rate cap is an option contract

[4] The Company stated that for these transactions, counterparties may be domestic and foreign securities firms, commercial banks, savings and loan institutions, insurance companies, and corporations (Exh. NEP-1, at 15).

between two parties: the purchaser of a cap and the seller of the cap (id.). Ms. Lee explained that the purchaser pays the seller a premium for the right to receive the excess of a referenced interest rate over a given rate (the strike rate) multiplied by the notional amount during the specified period (id.). The witness indicated that the purchaser of a cap, who is a borrower with variable rate debt, can benefit fully from interest rates falling and cap its exposure to rising interest rates at the strike rate (id.).

As described by the Company's witness, an interest rate collar limits the rate that a borrower with variable rate debt will pay between two levels, a cap and a floor (id. at 12). The Company stated that the buyer of a collar gives up the ability to pay lower interest rates below the floor and in general, a borrower buys a collar because the premium to purchase a collar is less than that for a cap (id. at 12-13). The Company stated that NEPCo would use caps and collars to take advantage of anomalies in the tax-exempt markets as well as hedge interest rate exposure (id. at 13).

According to the Company, there are risks associated with the use of swaps, caps, and collars: (1) market interest rate risk; and (2) credit risk of the counter-party (id.; Tr. at 23). The Company maintained that as long as there is an underlying liability to offset the hedge, the market interest rate risk is minimized (Tr. at 24). With regard to credit risk, the Company claimed that this risk can be minimized by transacting only with high credit, quality entities, incorporating credit-enhancing terms into the agreement such as collateral, letter of credit, or guarantee by the parent or the third party and by avoiding concentration of credit risk by using several counterparties if warranted by the size of the transaction (id. at 15). The witness stated that approval from NEPCo's Board of Directors is required before the Company can enter into any hedging transaction and that only officers of the Company are authorized to execute these types of agreements (id.). The Company asserted that these procedures provide internal control for hedging activities (id.).

In addition, the Company requests exemptions from the advertising and competitive bidding requirements of G.L. c. 164, § 15 and the requirement for Department approval regarding a company's investment of its funds pursuant to G.L. c. 164, § 17A (NEP-1, at 19). The Company states that it is seeking such an exemption, because under NEPCo's loan agreement with the Issuing Authorities, the Company is required to issue its additional G&R Bonds to the Issuing Authorities as security for the PCRBs to be issued by the Issuing Authorities to the public (id.).

III. STANDARD OF REVIEW

In order for the Department to approve the issuance of stock, bonds, coupon notes, or other types of long-term indebtedness[5] by an electric or gas company, the Department must determine that the proposed issuance meets two tests. First, the Department must assess whether the proposed issuance is reasonably necessary to accomplish some legitimate purpose in meeting a company's service obligations, pursuant to G.L. c. 164, § 14. Fitchburg Gas & Electric Light Company v. Department of Public Utilities, 395 Mass. 836, 842 (1985) ("Fitchburg II"), citing Fitchburg Gas & Electric Light Company v. Department of Public Utilities, 394 Mass. 671, 678 (1985) ("Fitchburg I"). Second, the Department must determine whether the Company has met

[5] Long-term refers to periods of more than one year after the date of issuance. G.L. c. 164, § 14.

the net plant test.[6] Colonial Gas Company, D.P.U. 84-96 (1984).

The Court has found that, for the purposes of G.L. c. 164, § 14, "reasonably necessary" means "reasonably necessary for the accomplishment of some purpose having to do with the obligations of the company to the public and its ability to carry out those obligations with the greatest possible efficiency." Fitchburg II, 395 Mass. at 836, citing Lowell Gas Light Company v. Department of Public Utilities, 319 Mass. 46, 52 (1946).

The Fitchburg I and II and Lowell Gas cases also established that the burden of proving that an issuance is reasonably necessary rests with the company proposing the issuance, and that the Department's authority to review a proposed issuance "is not limited to a `perfunctory review.'" Fitchburg I, 394 Mass. at 678; Fitchburg II, 395 Mass. at 842, citing Lowell Gas, 319 Mass. at 52.

In cases where no issue exists about the reasonableness of management decisions regarding the requested financing, the Department limits its Section 14 review to the facial reasonableness of the purpose to which the proceeds of the proposed issuance will be put. Canal Electric Company, et al., D.P.U. 84-152, at 20 (1984); see, e.g., Colonial Gas Company, D.P.U. 90-50, at 6 (1990).

Regarding the net plant test, a company is required to present evidence that its net utility plant (original cost of capitalizable plant, less accumulated depreciation) equals or exceeds its total capitalization (the sum of its long-term debt and its preferred and common stock outstanding) and will continue to do so following the proposed issuance. Colonial Gas Company,

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[6] The net plant test is derived from G.L. c. 164, § 16.

D.P.U. 84-96, at 5 (1984).

Where issues concerning the prudence of the Company's capital financing have not been raised or adjudicated in a proceeding, the Department's decision in such a case does not represent a determination that any specific project is economically beneficial to a company or to its customers. In such circumstances, the Department's determination in its Order may not in any way be construed as ruling on the appropriate ratemaking treatment to be accorded any costs associated with the proposed financing. See, e.g., Boston Gas Company, D.P.U. 95-66, at 7 (1995).

Regarding the Company's request for authority to enter into interest-swap agreements, the Department has found that when the particular interest rate swaps under consideration affect the interest rates of the company's proposed bonds, and by so doing, change the calculation of the benefits that these bonds may provide to the company's ratepayers, the Department has jurisdiction over these interest rate swaps pursuant to G.L. c. 164, § 14 and the interest rate swaps are subject to the standard of review applicable to the issuance of long-term debt. New England Power Company, D.P.U. 91-267, at 14 (1992). Thus, the Company must show that the interest rate swaps are reasonably necessary to accomplish a legitimate purpose associated with the Company's service obligations in accordance with G.L. c. 164, § 14. Id. at 15.

Pursuant to G.L. c. 164, § 15, an electric or gas company offering long-term bonds or notes in excess of $1 million in face amount payable at periods of more than five years after the date thereof must invite purchase proposals through newspaper advertisements. The Department may grant an exemption from this advertisement requirement if the Department finds that an exemption is in the public interest. G.L. c. 164, § 15. The Department has found it in the public interest to grant an exemption from the advertisement requirement where there has been a measure of competition in private placement. See, e.g., Western Massachusetts Electric Company, D.P.U. 88-32, at 5 (1988); Eastern Edison Company, D.P.U. 88-127, at 11-12 (1988); Berkshire Gas Company, D.P.U. 89-12, at 11 (1989). The Department also has found that it is in the public interest to grant a company an exemption from the advertisement requirement when a measure of flexibility is necessary in order for a company to enter the bond market in a timely manner. See, e.g., Western Massachusetts Electric Company, D.P.U. 88-32, at 5 (1988). G.L. c. 164, § 15, however, requires advertisement as the general rule; and waiver cannot be automatic but must be justified whenever requested.

Pursuant to G.L. c. 164, § 17A, no gas or electric company shall loan its funds to, guarantee or endorse the indebtedness of, or invest its funds in the stock, bonds, certificates of participation or other securities of, any corporation, association, or trust unless the said loan, guaranty or endorsement, or investment is approved in writing by the Department as consistent with the public interest. Bay State Gas Company, D.P.U. 91-165, at 5-8 (1992).

IV. CAPITAL STRUCTURE OF THE COMPANY

As of June 30, 1995, the Company's utility plant in service was $1,848,641,000 with construction-work-in-progress ("CWIP") of $381,589,000 resulting in a net utility plant excluding CWIP of $1,467,052,000 (Exh. NEP-4). As of June 30, 1995, the Company's capitalization consisted of $745,325,000 in long-term debt, $215,827,000 in common stock and premium on common stock, $60,516,000 in preferred stock, $288,000,000 in other paidin capital, less

$46,669,000 investment in Yankee Companies for a total capitalization of $1,262,999,000 leaving an excess of net utility plant of $204,053,000 after issuance of the bonds (id.).

V. ANALYSIS AND FINDINGS

1. G&R Bonds and PCRBs

Based on the foregoing evidence, the Department finds that the use of the proceeds of the proposed issuance of $68.35 million of G&R Bonds, in order to refinance the Series L and Series K G&R Bonds previously issued to support PCRBs, is reasonably necessary to accomplish the Company's service obligations in accordance with G.L. c. 164, § 14. The Department also finds that the interest rate ceiling of 12 percent on new G&R Bonds provides a degree of protection to NEPCo's customers and is in accordance with G.L. c. 164, § 14.

No issues have been raised in this proceeding concerning the Company's management decisions regarding the proposed capital financing. In approving this financing the Department makes no finding regarding the appropriate ratemaking treatment to be accorded any costs associated with the proposed financing.

In regard to the net plant test, the Company's total stock and long-term debt will not exceed the Company's net plant after the sale of the proposed issuance. Therefore, the

Department finds that the Company's existing net utility plant is sufficient to support the issuance and sale of $68.35 million of the G&R Bonds and that the proposed G&R Bond issue meets the net plant test.

2. Interest Rate Hedging Agreements

Regarding the Company's request for authority to enter into $410.35 million of hedging arrangements to include interest rate swaps, interest rate caps and interest rate collars, the Department finds that the particular hedging arrangements under consideration here affect the interest rates of the Company's G&R Bonds and, by so doing, changes the calculation of the benefits that these Bonds may provide to the Company's ratepayers. The Department therefore finds that the proposed hedging arrangements fall within the Department's jurisdiction pursuant to G.L. c. 164, § 14 and are subject to the standard of review applicable to the issuance of long-term debt.[7]

The Company has provided credible evidence that the interest rate swaps, interest rate collars and interest rate caps proposed as hedging arrangements, may result in savings for ratepayers. The record also shows that the risks associated with such hedging arrangements can be managed. Specifically, the Company has demonstrated that it has the financial strength as well as the expertise to limit those risks and realize benefits of the proposed hedging arrangements. Further, the Company has demonstrated that its proposed hedging arrangements would allow NEPCo the flexibility to take advantage of market conditions and still provide a degree of protection to the ratepayers. Therefore, the Department finds that the proposed hedging

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[7] The Department does not address here the issue of the extent of its jurisdiction over interest rate swaps that are not connected with the issuance of long-term debt.

arrangements are reasonably necessary to accomplish a legitimate purpose associated with the Company's service obligations in accordance with G.L. c. 164, § 14.

The Department also finds that the Company's request for continuing authority to issue the G&R Bonds and enter into interest rate swaps, interest rate caps and interest rate collars for notional amounts not in excess of $410.35 million through December 31, 2001, is reasonable since such authority relates solely to the refinancing of existing obligations and will not affect the Company's net plant test.

Regarding the Company's request for an exemption from the requirements of G.L. c. 164, § 15, the Department finds that it is appropriate to allow the Company the flexibility offered by the private placement process in order to assist the Company's timely entry into the financial markets. Therefore, the Department finds it is in the public interest to exempt the Company from the advertising and competitive bidding requirements of G.L. c. 164, § 15.

Regarding the Company's request for an exemption from the requirements of G.L. c. 164 § 17A, we find that it is appropriate to allow the Company the opportunity to invest the proceeds from the sale of the PCRBs, pending disbursement, to retire the Series L and Series K Bonds. Therefore, the Department finds that it is in the public interest to exempt the Company from the requirements of G.L. c. 164, § 17A, that investment of funds be approved in writing by the Department.

VI. ORDER

Accordingly, after due notice, hearing, and consideration, the Department

VOTES: That the issuance and sale by New England Power Company of: (1) up to

$68.35 million of General and Refunding Bonds; (2) the execution of one or more loan agreements or supplemental loan agreements in connection with refinancing outstanding PCRBs; and (3) the execution of one or more hedging arrangements as set forth herein are reasonably necessary for the purposes for which such issuances have been authorized; and it is

ORDERED: That the Department grants to New England Power Company its authorization and approval to issue one or more additional issues of G&R Bonds not exceeding $68.35 million principal amount provided that: (a) the additional G&R Bonds shall be sold on such terms (but within the limits set forth in this Order) as shall be determined by the directors of the Company or by the officers of the Company pursuant to delegated authority to match the interest rate, price, and other terms of the corresponding PCRBs issued by the BFA or CDA; (b) the additional G&R Bonds shall be secured, together with all bonds issued under the Company's G&R indenture, be a mortgage of the franchises and property now owned or hereafter acquired by the Company (except property of the character specifically reserved as aforesaid); and (c) the proceeds from the issuance of additional G&R Bonds hereby authorized shall be used for the purposes set forth herein; and (d) the term of the G&R Bonds issued pursuant to this Order not exceed 30 years; and it is

FURTHER ORDERED: That the Department authorizes the execution of one or more loan agreements or supplemental loan agreements between the Company and the Issuing Authorities in an aggregate principal amount not to exceed $68.35 million; and it is

FURTHER ORDERED: That the Department authorizes the execution of one or more hedging arrangements (interest rate swaps, interest rate caps, and interest rate collars) up to aggregate notional amounts not in excess of $410.35 million outstanding at any one time, such hedging arrangements to be entered into in conjunction with an issue of the additional G&R Bonds or other outstanding issues of G&R Bonds previously issued to support PCRBs on such terms as shall be determined by the directors of the Company or by the officers of the Company pursuant to delegated authority (but within the limits set forth in this Order); and it is

FURTHER ORDERED: That the Department authorizes, approves, and orders as in the public interest an exemption from Section 15 of Chapter 164 of the General Laws such that the Company need not invite bids for the proposed transaction thereof by publication in certain designated newspapers and that such issuance shall be exempt from the advertisement provisions; and it is

FURTHER ORDERED: That the Department approves as in the public interest, under G.L. c. 164, § 17A, the investment of funds from the issuance of additional PCRBs prior to the refunding of outstanding PCRBs; and it is

FURTHER ORDERED: That the Secretary of the Department shall within three days of the issuance of this Order cause a certified copy of it to be filed with the Secretary of the Commonwealth; and it is

By Order of the Department,

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John B. Howe, Chairman

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Mary Clark Webster, Commissioner

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Janet Gail Besser, Commissioner